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Ethics and Corporate Governance in the Fight against Corruption

Global Corporate Governance Forum

Article at a glance

- Building ethical businesses around the world commands the full spectrum of leadership and commitment within firms, countries, and the international community.
- Private sector efforts to fight corrupt practices should start with corporate governance, effective transparency, and disclosure mechanisms.
- A more integrated approach should also include codes of conduct, compliance programs, and initiatives to improve the ethical behavior and culture at all levels of a firm.
- Developing countries are not only sources of corruption, they are also the emerging frontiers in the global fight against bribery and extortion.

This article is based on the report of the International Consultation on the "Role of the Private Sector in Ethics and Corporate Governance in the Fight against Corruption," held in Paris on March 3, 2008 by the Global Corporate Governance Forum and the Center for International Private Enterprise. The full report can be found on the Global Corporate Governance Forum website, www.gcgf.org.

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Anti-corruption Progress in Context

“To make a difference in the fight against corruption, we need transparency-related reforms with spine, not rhetorical ones.”

Daniel Kaufmann, Director, Governance and Anti-Corruption, World Bank Institute

The past few decades have led to significant progress in building the institutional framework for transparency, accountability, and good governance in both the public and private sectors. In the private sector, improved corporate governance has led to major transformations in how companies are managed and controlled. The global fight against corruption is now also buttressed by legally-binding conventions from the Organization for Economic Cooperation and Development (OECD) and the United Nations (UN), as well as by numerous voluntary initiatives that continue to advocate for improved transparency and disclosure standards.

Transparency International, the Global Reporting Initiative, the UN Global Compact, the International Chamber of Commerce, and the World Economic Forum are only a few examples of organizations that have launched important voluntary initiatives that did not exist a decade ago.

Building the institutional framework for better companies and better societies is a learning process, where the public, private, and civil society sectors share mutual responsibility to strengthen good governance, particularly in the context of developing countries. All stakeholders must ensure that the rules of the game are written and applied for the benefit of all of society and not for the private gain of the few. If that is not the case, corruption can take its most extreme form: state capture, where a country is run for the benefit of political elites colluding with narrow private interests at the expense of the society at large.

The dangers of state capture are significant and real. But so are the benefits of improving governance in a given country. As Daniel Kaufmann and his team at the World Bank Institute have calculated, there is a 400 percent governance dividend derived from

reforms that achieve good governance and control corruption. This means that in the long run, countries that implement such reforms can achieve a four-fold increase in per capita income.

Today the sustainability agenda and business ethics are at the forefront of good governance debate, and the sensitive topics of bribery and corruption are no longer taboo in corporate board discussions. Still, challenges persist. The scale of annual bribery is estimated at US\$1 trillion worldwide. Only with collective effort from stakeholders across different facets of society – engaged in dialogue and learning how to advance the practice of new principles and standards (ethics, sustainability, collective action, anti-corruption, disclosure, etc.) – can true progress occur.

Fighting Corruption in Developing Countries

Fighting corruption in developing countries, whether through leveraging corporate governance, business ethics, or other tools, requires special consideration to factors that may be taken for granted in other settings. One special focus should be on strengthening the institutional framework that is a prerequisite for good governance, such as the judiciary, civil service, police, etc. Another is that corporate governance training – which mostly targets private sector actors – should also be extended to members of parliament and other senior public servants who must possess a solid understanding of corporate governance principles and how they affect private sector development and national competitiveness.

Experience suggests that standards of a voluntary nature seem to have a quicker market acceptance than those of a regulatory regime. The moment such standards are made compulsory, the learning process and the dialogue required to advance and perfect them is curtailed. In contrast, voluntary initiatives committed to improving governance and eliminating corruption – such as Transparency International’s Business Principles for Countering Bribery, the Global Reporting Initiative, the UN Global Compact, or the World Economic Forum’s Partnership Against Corruption – recognize that the solutions cannot

be provided by technicians and experts. Voluntary private sector approaches are more likely to make anti-corruption efforts an integral part of daily operations.

It is also important to keep in mind that the concept of state capture is central to understanding corruption and the feasibility of designing and implementing anti-corruption initiatives. State capture refers to a situation when the policymaking power of the state is captured by vested interests – whether individual, corporate, familial, or any other – resulting in rules that are written and applied for the benefit of the few. At a national scale, it is tantamount to having the leadership of a country and a handful of individuals forming a joint venture to run the country at the expense of the larger society.

The effects of state capture are deeply corrosive. It occurs in both developing and developed countries, at times becoming very difficult to detect elaborate networks and mechanisms by which the country's leadership and special interests form corrupt partnerships. Therefore, a crucial goal of a global fight against corruption must be to introduce reforms that expose and help break the relationships of state capture.

The Three Rules of Business Enterprise

“We must keep in mind that firms have to take risks. If they are not taking risks, they are probably not innovating and not generating profits for their shareholders”

*- John D. Sullivan
Executive Director, CIPE*

Risk is inherent to doing business, innovation, and the entrepreneurial spirit; however, it can be managed to serve both the interests of companies and society. The duty of care, the duty of loyalty, and the business judgment rule are three key principles to help business executives manage risk while advancing the private goals of a company and the collective interests of society, particularly with respect to fighting corruption. If boards and managers fail in their collective and individual responsibilities, as is often the case in corruption scandals, the company, the shareholders, and ultimately society bear the costs

and consequences.

The three rules also point to the important topic of values and ethics in business. They are increasingly recognized as foundational elements of good corporate governance, creating an organization that acts and functions on the basis of certain values and standards, whether stemming from obligatory regulations or internal culture. This is not a moral argument. Rather, incorporating ethical standards into how businesses operate day-to-day is about properly diagnosing business risks, understanding the values that in turn guide actions, and reporting in a transparent manner corporate performance against these established standards.

The business case against corruption is fundamental to having an efficient economic system. Market economies depend on what Adam Smith conveyed through his book, *The Theory of the Moral Sentiments*, namely, that the interaction among individuals (i.e., the free market) is based on a series of ethical premises. Consequently, business ethics and fighting corruption should never be conceived as a sequential issue; it is never about causality from one to the other. They simultaneously contribute to and are part of the solution for good corporate governance.

From a broader perspective, corporate governance is therefore a framework of values and rules to “do the right thing” as defined by markets, economic efficiency, sustainability, ethics, shareholders, and other stakeholder. Fundamentally, the challenge is to maintain a balance between the three rules with incentives that help company decision-makers and board members fulfill their basic duties while protecting the business judgment of profit maximization.

Balancing Profitability and Sustainability

“The abuse of entrusted power for private gain is always fine for the one person doing it, but it becomes catastrophic if everybody starts doing it.”

*- David Pitt-Watson, Chairman, Hermes Equity
Ownership Services*

The challenges of today's changing world are giving rise to problems that have a direct effect on how

businesses operate. Issues that in the past were not considered central to the bottom line are now forming part of a company's balance sheet. As a result, over the past few years, the profit-based framework for business decision-making has experienced growing expansion to broader strategic considerations that concern environmental, social, and governance issues. This process – commonly referred to as the expansion from single to double, triple, and higher bottom lines – is an important development that cannot and should not be ignored in structuring anti-corruption initiatives. The point to remember, however, is that ultimately companies are accountable to shareholders and owners based on the principle of the single bottom line.

If the bottom line – a company's financial performance – is the basic principle driving entrepreneurial behavior and decisions, then the issue of incentives becomes central to how a company will weigh costs and benefits in choosing whether to reject or engage in corrupt acts. The nature, design, costs, and effectiveness of the regulatory framework, transparency standards, anti-corruption legislation, rule of law, ethical principles, to name a few elements, all play a major role in altering the basic equation of costs and benefits.

The dilemma of corruption is that though companies may recognize that it is wrong to engage in corrupt acts, there will always be a short-term advantage to those individual companies that opt to do so. If all businesses agreed that there should be no corruption, all would be better off; but if one business cheats, the practice quickly spreads to other firms. Thus, the incentives prism is a valuable tool to consider the merits of anti-corruption initiatives. There will always be individuals that misperceive or consciously abuse risk, so the key challenge is to work at a systemic level through the mechanisms of corporate governance and collective action to change the balance to where the risks of corruption are so high that companies will have no incentive to participate in it.

Investor responsibility in remaining anxiously vigilant, to use Adam Smith's phrase, is a simple and practical step that makes a huge difference in pushing back corruption. Although institutional investors can

be powerful agents of change simply because of the nature of their role in business, "activist" investors are necessary to realize the potential leverage of their influence. The need for such activism particularly emerges in the context of weak governance where market institutions and corporate governance mechanisms have limitations as levers of change. In such contexts, activism can be a way to make companies forcefully aware that institutional investors attach significant value to combating corruption when making investment decisions.

The Regulatory Framework

Determining the right balance of regulatory oversight should always be a measured and reasoned evaluation of costs, benefits, and the incentives and disincentives it can generate for private sector development. Two distinct but equally important issues concern the regulatory framework: one is the balance between too much or not enough regulation, and the second is the degree of enforcement. The latter issue takes on an even greater importance when viewed from its considerable variance across countries. In countries with weak rule of law, a whole set of basic governance and development challenges arise before one can begin to address the right balance of regulatory oversight.

Assuming that regulations are enforced, the balance of regulatory oversight can become either a powerful incentive or disincentive for reform. In the aftermath of major corruption scandals, the automatic response typically is a call for more and broader regulation. The current debate in the United States on the benefits of the Sarbanes-Oxley Act of 2002, for example, centers on an issue that many other countries are struggling with, namely, the balance between costs and benefits of corporate governance reforms – especially as they differ between larger and smaller companies. In order to be productive and useful, these debates must examine at what threshold corporate governance reforms inhibit innovation and risk-taking to the point that they undermine private enterprise and capital markets, which are the fundamentals of the very system that they aim to protect.

However, even in markets with underdeveloped institutions and weak regulatory frameworks, it is still possible to achieve meaningful progress towards good corporate governance. Recent research in Nigeria, for example, revealed that despite the challenges posed by weak governance institutions, effective corporate control mechanisms were achieved through a rating system that tracked company behavior in five areas: internal controls, basic regulatory compliance, accountability practices, value system, and track record with these issues. The important point is that there are ways to find practical solutions to overcome the challenges, while at the same time promoting the application of best practice standards. Of course, changing ineffective legislation should be a long-term focus on the private sector side rather than simply devising short-term solutions.

Transparency Reforms

Transparency is an indispensable tool in recognizing the risks of corruption. Though it is useful to correct the weaknesses of corporate governance controls exposed by breaches of corruption, it is even more productive to identify and manage risks before they lead to a crisis. Therefore, transparency-related reforms are fundamental to recognizing the risks of corruption, particularly as tools for preventive and early-warning systems.

The private sector is often the subject of low credibility, particularly in the aftermath of grand corruption scandals. Business can help reverse this trend by being more open about its operations. Disclosure is an important company strategy, especially when it is designed to engage a broad community of stakeholders in finding solutions to identified risks, and not as a public relations exercise. Mechanisms that foster greater transparency and disclosure, buttressed by independent review, also represent alternatives to more regulation. In contrast with excessive regulation, which often has the effect of suffocating the market, transparency measures voluntarily adopted by companies allow for better informed market players and, in turn, better informed decisions within the marketplace.

Effective board accountability, independent monitoring, relevant measures of performance accountability and assurance, improved global accounting standards, and collective blacklists of corrupt companies are just a few such transparency-enhancing means to combat corruption. The role of the media is also central to strengthening transparency in both the public and private sectors. Free media is a powerful mechanism to ensure that companies that join voluntary corporate citizenship initiatives in fact do keep up with their promises. More generally, the media's watchful eye and investigative journalism focused on anti-corruption, ethics, and good corporate governance have the power to put these issues on the public agenda. Support for independent media and the protection of media freedoms is therefore a key step in advancing transparency and disclosure.

Building Ethical Organizations

“If you want to succeed in building a sustainable business at any point in time, you need to have good people to act as the cornerstone of your growth. The fact is that you cannot attract or retain top talent if you engage in corrupt practices.”

-Tawfik Diab, Managing Director, PICO Petroleum, Egypt

Committed action and leadership can turn even corruption-prone environments into best practice models of ethical business organizations. Although it requires investment, the resources devoted to building a corrupt-free environment and an ethical culture provide companies with solid foundations for long-term competitiveness and sustainability. All too often when companies strive to fight corruption they tend to focus too much on negative corrections such as sanctions and terminations. But a values-based strategy is equally important for building a culture of ethics that helps protect against the risks of corruption while also helping to improve financial performance.

The following key lessons are powerfully relevant to solutions aimed at reducing corruption and building ethical business organizations. Each lesson is increasingly harder to implement, but the results can be achieved through committed leadership:

- **Ownership:** the first step is to clearly establish who owns and who is accountable for the ethics agenda within a company.
- **Policy:** a company should establish clear ethical standards, which are generally reflected in a code of ethics based on internationally accepted norms; all employees should be able to fully understand in simple terms what is expected of their behavior.
- **Communication:** ethical organizations spend a lot of time communicating their standards to employees, using every opportunity for interaction (training, email, newsletters, retreats, award ceremonies, milestone celebration, etc.) to reinforce the values that define the company's culture.
- **Measurement:** ethical organizations measure their level of compliance in order to understand the degree to which they are abiding by the standards that they set for themselves.
- **Enforcement:** this is the hardest step to undertake, but holding employees at all levels of the organization accountable on a consistent basis is key to building the credibility of a company's ethical standards.
- **Balance:** the introduction of aggressive controls can result in an unhealthy internal atmosphere of fear and resentment among employees; the parallel application of commitment-based strategies is necessary to ensure that better business performance goes hand in hand with employee empowerment, building a unified vision of the company's new ethical standards and staving off future risks of corruption.

The Small and Medium-Sized Enterprise (SME) Sector

Much of the global anti-corruption debate and many of the proposed initiatives take place from the perspective of large publicly traded corporations. Although corporate governance principles, such as transparency and accountability, apply equally to other business forms – such as family-owned firms, SMEs, cooperatives, and state-owned enterprises (SOEs) – significantly less attention is devoted their specific needs in improving governance. In order to

be effective, anti-corruption strategies and initiatives – whether pursued through legally-binding or voluntary standards, domestically or internationally – should be better tailored to the circumstances of different business structures.

Because of their large number in most economies and the implications that they have for national growth and development, special attention must be devoted to SMEs. They should not be afterthoughts in the design of major policies and reforms that are done with large public corporations in mind. Anti-corruption initiatives ought to in particular take into account the constraints faced by those smaller entities that do not have the deep pockets of global corporations. They cannot simply be added to the reforms that were designed for large public corporations.

Corruption in supply chains directly leads to a consideration of corporate governance in SMEs and family-owned businesses in developing countries. They are major players in global supply chains and in very large numbers, which makes it even harder to control against all types of inappropriate practices. Global corporations face increasing difficulties in controlling corruption the further down the supply chain they go. Often when a corporation cancels contracts from a particular supplier due to inappropriate business practices, the same supplier simply moves to a new location under a new name. The more flagrant offenders establish mirror factories, so if auditors paid a visit they would be taken to a model facility. Therefore, while keeping reporting and disclosure requirements for SMEs as simple as possible, an important goal in designing these requirements should be to prevent SMEs from becoming corruption conduits for higher levels in the supply chain.

Conclusion

The key to fighting corruption and improving governance around the world lies in designing and implementing practical initiatives that provide businesses of all sizes with easy-to-use tools to make their operations more transparent, accountable, and ethical. Overly complicated or abstract standards inevitably fail to affect change because they are difficult

to adhere to and run the danger of remaining in the realm of lofty rhetorical pronouncements that – in the words of Daniel Kaufmann – have no spine.

Equally important is the issue of commitment on the part of both public and private sectors to reform. If government and business leaders are not committed to anti-corruption or do not have the will to institute changes, it does not matter what mechanisms or systems are out there and whether these are legally binding or voluntary in nature. Implementing gradual steps such as codes of ethics and journalist training can only be effective if it is accompanied by broader reforms that affect the enabling environment: judicial reform, media freedom, procurement transparency, etc. Without these broader reforms, bottom-up anti-corruption initiatives will have limited impact.

Excessive regulation on the one hand and lack of transparency on the other are fertile ground for bribery and corruption. Strategies, solutions, and initiatives to address the proper balance between the two will differ across countries. It is important to keep in mind that the overall aim of transparency reforms is to support, not undermine, private sector development, particularly in developing countries and for SMES that are so critical to poverty reduction. Business ethics and good corporate governance initiatives are not about imposing Western principles. Rather, they are about internationally accepted values and norms, and how businesses – wherever they are – can be trusted to use the capital invested in them in a responsible and ethical manner.

At one level, preventing the abuse of this entrusted capital involves monitoring and control systems that comprise corporate governance. At another level, and perhaps the most important one, good corporate governance rests upon a framework of ethics and values. This is not a morality argument. Business ethics and anti-corruption are fundamentally complementary to the larger framework of identifying and managing business risks, and of balancing company and communal goals. A large part of the solution is creating the incentives for decision-makers to honor the three rules of business enterprise through proper disclosure. The key is to identify and share international best

practices and to adapt them to different contexts. Consequently, fighting corruption requires global dialogue and a learning process among stakeholders committed to good governance.

The full conference report can be found at [http://www.gcgf.org/ifcext/cgf.nsf/AttachmentsByTitle/Corruptionconsultationmarch08/\\$FILE/Forum-CIPE+Paris+Consultation-Proceedings+Report+1-20.pdf](http://www.gcgf.org/ifcext/cgf.nsf/AttachmentsByTitle/Corruptionconsultationmarch08/$FILE/Forum-CIPE+Paris+Consultation-Proceedings+Report+1-20.pdf).

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